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"EMPLOYEE STOCK OWNERSHIP PLANS: UNCERTAINTIES PLAGUING THE DUTIES OF THE ESOP FIDUCIARY WITH RESPECT TO VOTING AND DEFENSIVE ESOPS"

*"Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions (Wendt v. Fischer, 243 N. Y. 439, 444). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court."*¹

I. INTRODUCTION

An Employee Stock Ownership Plan ("ESOP") is a qualified retirement plan designed to invest primarily in employer stock,² thus providing plan participants and their beneficiaries with an ownership interest in their employer.³ As a means to protect employee retirement benefits, Congress enacted the Employee Retirement Income Security Act of 1974 (ERISA).⁴ The ESOP surfaced

¹ Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Justice Cardozo distinguishes the elevated level of conduct which fiduciaries must exercise with that level of conduct which parties to an ordinary business transaction must exhibit).

² I.R.C. § 4975(e)(7) (1998); ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6) (1998).

³ William R. Levin, Note, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 148 (1985). ERISA defines an ESOP as "an individual account plan . . . which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of the Internal Revenue Code of 1954, and which is designed to invest primarily in qualifying employer securities" ERISA § 407 (d)(6), 29 U.S.C. § 1107(d)(6). Similarly, the Internal Revenue Code defines an ESOP as "a defined contribution plan . . . which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a) [defined contribution plans] and which are designed to invest primarily in qualifying employer securities." I.R.C. § 4975(e)(7). Additionally, the ESOP must meet the requirements of I.R.C. § 409(h) (repurchase obligations), I.R.C. § 409(o) (voting requirements of §409(e) for employers holding registration type securities), and I.R.C. § 409(n) (tax-free rollovers described in I.R.C. § 1042). I.R.C. § 4975 (e)(7)-(8).

⁴ 29 U.S.C. §§ 1001-1461, Pub. L. No. 93-406, 88 Stat. 829 (1974). See also ERISA FIDUCIARY LAW 203-04 (Susan P. Serota et al. eds., BNA 1995).

officially with the enactment of ERISA,⁵ yet the idea of such a retirement vehicle was conceived pre-ERISA.⁶ Louis O. Kelso and Senator Russell B. Long introduced the ESOP and encouraged Congress to adopt it within its ERISA legislation.⁷ Today, U.S. employers sponsor more than ten thousand ESOPs which cover over eleven million employees.⁸

The increased use of ESOPs, particularly in the 1980's with the rise of corporate mergers and hostile takeovers,⁹ made it necessary for federal courts to interpret ERISA's fiduciary standards as applied to ESOP plan fiduciaries.¹⁰ Unlike other qualified retirement plans, ESOPs allow its participants to invest in employer securities.¹¹ Consequently, ESOP fiduciaries confront significant dilemmas which other plan fiduciaries do not face.¹² These include valuation issues, employer-fiduciary conflicts of interest, the questionable use of defensive ESOPs, and voting rights.¹³

⁵ Matthew M. O'Toole, Comment, *The Disproportionate Effects of an ESOP's Proportional Voting*, 85 NW. U. L. REV. 824, 824-25 n.3 (1991) (writing that "the overall goal of ERISA was to strengthen the nation's private pension system"). See also Erza S. Field, Note, *Money For Nothing and Leverage For Free: The Politics and History of the Leveraged ESOP Tax Subsidy*, 97 COLUM. L. REV. 740, 740-41 (1997) (indicating that "ESOPs were an add-on to the Employee Retirement Income Security Act of 1974 ('ERISA'), inserted by Senate Finance Committee Chairman Russell Long").

⁶ Levin, *supra* note 3, at 151 n.11, (noting that ESOPs were first discussed in the Regional Reorganization Act of 1973 which mandated that Conrail, a government-owned railroad, consider implementing an ESOP). See also Jeffrey R. Gates, *A Brief History of U.S. ESOP Legislation*, 3 J. EMPLOYEE OWNERSHIP L. & FIN. 34, 40 (1991) (writing about Senator Long's ideas of "employee capitalism").

⁷ Levin, *supra* note 3, at 158 (discussing Senator Long's view that a small number of capitalists weakens the American economy). Levin quotes Senator Long, stating that "[a] continuing fundamental weakness of our system is that so many Americans own so very little while a relative few Americans own a great deal." *Id.* at 158 n.43. See also Gates, *supra* note 6, at 36-40 (writing about Senator Long's view that ESOPs will create a more broadly financed capitalist system).

⁸ John L. Utz, *ERISA Basics: A Primer on ERISA Issues (Employee Stock Ownership Plans)*, A.B.A. CTR. FOR CONTINUING LEGAL EDUC. NAT'L. INSTITUTE (1997) (available in N97EBAB ABA-LGLED T-1).

⁹ *Growth of Plans Continued During 1988, NCEO Study Finds*, 16 Pens. Rep. (BNA) No. 32, 1457 (Aug. 7, 1989).

¹⁰ See generally ERISA §§ 403, 404, 29 U.S.C. §§ 1103, 1104 (1998) (discussing the establishment of a trust and fiduciary duties, respectively).

¹¹ I.R.C. § 4975(e)(7) (1998); 29 U.S.C. § 1107(d)(6)(1998).

¹² *Donovan v. Cunningham*, 716 F.2d 1455, 1467-68 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251(1984). See also ERISA FIDUCIARY LAW, *supra* note 4.

¹³ Laurence B. Wohl, *Fiduciary Duties Under ERISA: A Tale of Multiple Loyalties*, 20 U.

This article will examine two particular dilemmas that challenge ESOP fiduciaries: voting rights and the use of defensive ESOPs. First, this article will discuss the development of ESOPs and their general mechanics.¹⁴ Second, it will explore the creation of ERISA, including the policy behind the statutory scheme.¹⁵ It will then set forth ERISA fiduciary law, noting the interplay of ERISA fiduciary standards and trust law.¹⁶ Third, this article will address problems confronting the ESOP fiduciary, specifically, voting and tendering shares of ESOP stock and the effect of using an ESOP as an anti-takeover device.¹⁷ In doing so, this article will look not only at how federal courts have interpreted and applied ERISA fiduciary standards to ESOP fiduciaries, but will also critique the standards which the Department of Labor have proposed to police this area.¹⁸ Finally, it will suggest simpler yet more definitive standards than those which the courts and the Department of Labor have formulated, in an attempt to provide workable guidelines for ESOP fiduciaries to follow in the exercise of their duties.¹⁹

II. THE DEVELOPING ESOP

A. *ESOP Mechanics*

An ESOP is a qualified stock bonus plan and/or money purchase plan designed to invest primarily in qualifying employer securities,²⁰ and which must

DAYTON L. REV. 43, 44 (1994). *See also* Eric Grannis, Note, *A Problem of Mixed Motives: Applying Unocal to Defensive ESOPs*, 92 COLUM. L. REV. 851, 851 (1992) ("explaining one area of continuing uncertainty is the judicial supervision of defensive Employee Stock Ownership Plans (ESOPs)."); Daniel Fischel and John Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1126 (1988) (writing that "[t]he most visible problem with ERISA's exclusive benefit rule arises from section 408(c)(3), which allows the employer or other plan sponsor to have its own 'officer, employee, agent, or other representative' serve as trustee or other fiduciary"); Field, *supra* note 5, at 758-59 (indicating that when an ESOP overpays for securities, the proceeds used to acquire those securities have inured partially to benefit a third party).

¹⁴ *See infra* PART II(A).

¹⁵ *See infra* PART II(B).

¹⁶ *See infra* PART II(B).

¹⁷ *See infra* PART III.

¹⁸ *See infra* PART III.

¹⁹ *See infra* PART III.

²⁰ ERISA and the Internal Revenue Code define "qualifying employer security" differently. The Internal Revenue Code provides a more restrictive definition, and thus, takes precedence over ERISA's definition. *Compare* ERISA § 407(d)(5), 29 U.S.C. § 1107(d)(5) (1998) *with* I.R.C. § 4975(e)(8) (1998). ERISA § 407(d)(5) identifies a qualifying employer security as "(A) stock, (B) a marketable obligation (as defined in subsection (e)), or (C) an interest in

meet the requirements set forth by the Secretary of the Treasury.²¹ Although other qualified plans may invest in employer stock, these plans may invest only up to 10% of the fair market value of plan assets in employer's securities.²² ERISA exempts "eligible individual account plans" such as ESOPs, profit-sharing plans, and stock bonus plans from this requirement and allows their investments to exceed the 10% limitation.²³ Unlike most qualified plans, ESOPs are exempt from ERISA's prohibited transaction rules,²⁴ and thus may engage in transactions with parties in interest²⁵ to the plan, provided the sale or acquisition is for adequate consideration and no commission is procured with respect to that sale or acquisition.²⁶ Furthermore, provided certain conditions are met, ESOPs are permitted to borrow money.²⁷

a publicly traded partnership . . . , but only if such partnership is an existing partnership I.R.C. § 4975(e)(8) defines a "qualifying employer security" as "an employer security within the meaning of section 409(l)." I.R.C. § 409(l) defines a qualifying employer security with respect to whether an employer holds publicly tradeable securities. *See generally* Treas. Reg. § 54.4975-7(b)(1)(iv)(1977); Priv. Ltr. Rul. 8727025 (April 12, 1987); Priv. Ltr. Rul. 9529043 (April 28, 1995).

²¹ ERISA § 407(d)(6), 29 U.S.C. § 1107(d)(6); I.R.C. § 4975 (e)(7)-(8). An ESOP must comply with the requirements proscribed in Treas. Reg. § 54.4975-11 (1977).

²² ERISA § 407(a)(2), (b), (d)(3)(A), 29 U.S.C. § 1107(a)(2), (b), (d)(3)(A)(1998).

²³ *Id.*

²⁴ *See infra* note 83.

²⁵ ERISA § 3(14), 29 U.S.C. § 1002(14)(1998) defines a "party in interest" to include fiduciaries, services providers, employers, employee-participants, directors, officers, partners, joint venturers of the plan, or relatives of the individuals described above.

²⁶ *See infra* note 84 and accompanying text. The Department of Labor has attempted to define "fair market value," central to the definition of adequate consideration, as "the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell." Definition of Adequate Consideration, 53 Fed. Reg. 17,632, 17,634 (1988) (to be codified at 29 C.F.R. pt. 3510) (proposed May 17, 1988). The Department of Labor's definition of fair market value requires an ESOP fiduciary to sufficiently justify that the price he or she accepted for the stock was fair. H.R. REP. NO. 93-1280, at 133-34 (1974); *see also Correspondence on Proposed Leveraged Buy-out of Blue Bell, Inc.*, 12 Pens. & Ben. Rep. (BNA) 52 (1985). This differs from the ordinary business definition of "adequate," and thus is incompatible with ERISA's definition in § 3(21). Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 121 (1986) (a price may be adequate, yet not fair). The standard articulated by the Department of Labor provides little guidance for ESOP fiduciaries and has left them to question the price they may receive for purchased securities without violating ERISA's prohibited transaction rules.

²⁷ ERISA § 408(b)(3), 29 U.S.C. § 1108(b)(3)(1998) and I.R.C. § 4975(e)(7)(1998) (providing that ESOP loans must primarily benefit plan participants and their beneficiaries

To establish an ESOP, an employer must execute a trust agreement, setting forth the plan terms and the rights of the participants and their beneficiaries.²⁸ The agreement must functionally designate plan fiduciaries who will manage and administer the plan.²⁹ Additionally, a trust must be established to hold the plan assets.³⁰

Once created, the ESOP Fiduciary can invest in qualifying employer securities which may be obtained from a corporate shareholder, directly from the employer, or if the employer stock is a "section 6" security, on the open market.³¹ Commonly, ESOPs cannot fund a large purchase of stock and must rely on institutional lenders to supply the capital.³² Often, these lenders are reluctant to finance such an investment, and thus, the ESOP must rely on a "back-to-back" ESOP loan such that the employer borrows money from the bank and, in turn, lends it to the ESOP to finance the securities.³³ After the stock is purchased, it is placed in an unallocated expense account, and subsequently, allocated to the plan participants' accounts as the loan is repaid.³⁴ ESOPs which use loan proceeds to purchase qualifying employer securities are known as "leveraged" ESOPs.³⁵

The essence of an ESOP is that it is both a qualified employee benefit plan and a method of corporate finance.³⁶ The legislative goal of establishing ESOPs

and bear a reasonable rate of interest).

²⁸ ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1)(1998).

²⁹ *Id.* Examples of such fiduciaries include plan administrators, plan trustees, and investment managers.

³⁰ *Id.* § 403(a), 29 U.S.C. § 1103(a)(1998).

³¹ MICHAEL J. CANAN, QUALIFIED RETIREMENT AND OTHER EMPLOYEE BENEFIT PLANS 126 (1997). Treas. Reg. § 54.4975-7(b)(1)(iv) states that publicly traded securities are those registered under § 6 of Securities Exchange Act of 1934.

³² CANAN, *supra* note 31.

³³ *Id.*

³⁴ *Id.* See also Treas. Reg. § 1.401-1(b)(ii)-(iii) (1986); 26 C.F.R. § 54.4975-11(d) (1989) (allocation rules); Treas. Reg. § 54.4975-7(b)(8)(i)-(iii) (1977) (rules governing the release of securities from a suspense account).

³⁵ CANAN, *supra* note 31.

³⁶ Levin, *supra* note 3, at 148 n.2 "[Leveraged ESOPs] can be used for financing corporate growth, tender offers, acquisitions, going private, or increasing the corporations working capital. Leveraged ESOPs are thought to be especially useful in mergers and divestitures of subsidiaries and shareholder buy-outs." *Id.* J. Kaplan & R. Ludwig, ESOPS A-16 (BNA Tax Mgmt. Portfolio No. 354-2nd, 1983). See also 129 Cong. Rec. S16, 629, S16, 636 (daily ed. Nov. 17, 1983), wherein, Senator Russell Long suggested "ERISA made it clear that the ESOP is a technique of corporate finance that utilizes the advantages of a tax-exempt employee benefit trust to encourage the financing of corporate transactions in such a way that

was to extend corporate ownership to the average worker.³⁷ In support of ESOP development, Congress introduced tax incentives to those assisting in the formation of ESOPs.³⁸ Leveraged ESOPs offer the most substantial tax advantages to plan participants, institutional lenders providing ESOP loans, and corporations which sponsor these plans.³⁹

First, ESOPs remain the only qualified retirement vehicle permitted to borrow funds to purchase stock,⁴⁰ both the interest payments on the loan and payments on the principle are tax deductible.⁴¹ Interest payments are fully deductible, but principal payments are treated as employer contributions to the plan and are deductible only up to 25% of the total compensation of participants covered under the plan.⁴²

Second, a corporation may qualify for a deduction with respect to dividends paid on ESOP stock.⁴³ Generally, a corporation may not deduct the dividends it pays with respect to its stock.⁴⁴ However, when certain conditions are met, a

employees will have an opportunity to earn an ownership stake in their employer." Other reasons suggested for the use of ESOPs include their tax benefits, their use as defensive measures in takeover contests, and their ability to increase employee productivity. Field, *supra* note 5.

³⁷ 128 Cong. Rec. s33813 (daily ed. Nov. 17, 1983) (emphasizing that ESOPs will enhance productivity and distribute the wealth). The establishment of the ESOP was a proposed answer to the inequities present in America's capitalist structure. *Id.* at s16630. *See also* Levin, *supra* note 3, at 158 (identifying Congressional claims of certain benefits perceived to emanate from ownership expansion, including "1) new wealth and productivity for the economy, 2) a chance for workers to accumulate a capital estate; 3) more jobs; . . . 7) preservation of the marginal enterprise . . ."); *But see* William Levin, *Are Leveraged Buyouts Fatally Flawed?*, WALL ST. J., Apr. 4, 1985, at 30 "The root problem with leveraged employee buyouts is the leverage . . . Debt doesn't justify a tax bonanza. But debt of this magnitude does hurt workers, the companies they would own and the economy as a whole." *Id.*

³⁸ Tax Reform Act of 1984, P.L. 98-369; Tax Reform Act of 1986, P.L. 99-514 (introducing tax incentives to lending institutions providing ESOP loans and to employers maintaining such plans); Tax Management Portfolios, U.S. Income, ESOPs, 354 Tax Mgmt. 5th (BNA) 1 (1997).

³⁹ Levin, *supra* note 3 at 148 (discussing leveraged ESOPs as a way to create corporate capital).

⁴⁰ ERISA § 408(b)(3), 29 U.S.C. § 1108(b)(3) (1998); I.R.C. § 4975(d)(3) (1998).

⁴¹ I.R.C. § 404(a)(9)(1998).

⁴² *Id.*

⁴³ I.R.C. § 404(k)

⁴⁴ I.R.C. § 301(c)(1), § 316.

corporation can receive a deduction for dividends paid with respect to ESOP stock.⁴⁵ Dividends are deductible if they are paid in cash to ESOP participants, if they are paid directly to the ESOP, and subsequently, distributed to the plan participants in cash not more than 90 days after the close of the plan year in which they were paid, and if they are used to repay an ESOP loan used to acquire the securities on which the dividends were paid.⁴⁶

Third, a leveraged ESOP may provide an advantage to the institution issuing the loan. Prior to the Small Business Job Protection Act of 1996, Internal Revenue Code § 133 allowed lending institutions and corporations engaged in the business of lending money to exclude 50% of the interest it received on the ESOP loan.⁴⁷ This exclusion no longer applies to loans made after August 20, 1996.⁴⁸ However, the exclusion still applies to loans made on or before August 20, 1996 and loans used to refinance ESOP loans made on or before August 20, 1996, provided certain conditions are met.⁴⁹

Fourth, employees who participate in leveraged ESOPs may be allowed greater annual additions to their individual accounts. Internal Revenue Code § 415 limits annual contributions made to a participant's account by either employee contributions, employer contributions or forfeitures to the lesser of 25% of compensation or thirty thousand dollars.⁵⁰ This limitation is extended for leveraged ESOPs in which employer contributions to highly compensated employees⁵¹ do not

⁴⁵ I.R.C. § 404(k).

⁴⁶ *Id.* Before the enactment of the Tax Reform Act of 1986, dividends were deductible only to the extent the corporation paid them to allocated shares. Utz, *supra* note 8, at 6. The Tax Reform Act of 1986 permitted dividend deductions on unallocated shares. *Id.* Corporations quickly took advantage of this change and began to sell convertible preferred stock which paid a higher dividend rate than the common stock to the ESOP. *Id.* The transaction's beauty was that dividends paid on ESOP stock effectively increased the ESOP loan which the corporation could finance with tax deductible payments. *Id.* With the enactment of the Omnibus Budget-Reconciliation Act of 1989, corporations no longer automatically received a deduction on dividends used to repay ESOP loans. *Id.*

⁴⁷ Rev. Rul. 89-76, 1989-1 C.B. 24; I.R.C. § 133 (repealed in 1996).

⁴⁸ Small Business Job Protection Act of 1996 § 1602(c)(1), P.L. 104-188, (codified as amended in scattered section of 26 U.S.C.).

⁴⁹ *Id.* Small Business Job Protection Act § 1602(c)(2) delineates certain requirements which must be met for the interest exclusion to apply. For the interest exclusion to apply: (1) the loan must meet the requirements of I.R.C. § 133; (2) the principal amount of the loan after the refinancing must not exceed the principal amount of the loan before the refinancing; and (3) the term of the refinancing loan must not extend beyond that of the original loan. *Id.*

⁵⁰ I.R.C. § 415(c)(1998).

⁵¹ I.R.C. § 414(q).

exceed 1/3 of all employer contributions to the plan.⁵² Under these circumstances, § 415 annual contributions will not include forfeitures of employer stock which have been procured from either the proceeds of an ESOP loan or interest from loan payments.⁵³

Finally, Internal Revenue Code § 1042(a) allows a shareholder who sells "qualified securities"⁵⁴ to an ESOP, and subsequently, acquires "qualified replacement property"⁵⁵ either three months before, or twelve months following the sale of the stock,⁵⁶ to defer long-term capital gain recognition on the sale of that stock until the shareholder sells the qualified replacement property.⁵⁷ For § 1042(a) to apply, the shareholder must not be a C corporation,⁵⁸ must elect the application of § 1042, and must meet the requirements of § 1042(b).⁵⁹

B. ERISA Fiduciary Standards and the Duties of the ESOP Fiduciary

Congress enacted ERISA as a means of protecting employee retirement benefits and of monitoring an employer's management of its employee benefit plans.⁶⁰ The heart of ERISA lies in Title I which governs fiduciary conduct, administration, prohibited transactions, and security requirements.⁶¹ Three distinct authorities share the responsibility for interpreting Title I and administering the statute: the federal courts, the Department of Labor, and the Internal Revenue Service.⁶² Although the Department of Labor has primary authority to administer the statute's fiduciary laws, each of these authorities has articulated its own standards and procedures to govern employers and fiduciaries⁶³ in the

⁵² I.R.C. § 415(c)(6).

⁵³ *Id.*

⁵⁴ I.R.C. § 1042(c)(1); § 409(l) (certain domestic corporation securities).

⁵⁵ I.R.C. § 1042(c)(4) (stating that "any security issued by a domestic operation corporation which (i) did not, . . . have passive investment income . . . (ii) is not the corporation which issued the qualified security which such security is replacing or a member of the same controlled group of corporations . . .").

⁵⁶ I.R.C. § 1042(c)(3).

⁵⁷ I.R.C. § 1042(e)(1) (mandating that the shareholder recapture any gain deferred on the sale of qualified securities upon the ultimate disposition of the qualified replacement property).

⁵⁸ I.R.C. § 1042(c)(7).

⁵⁹ I.R.C. § 1042(a).

⁶⁰ ERISA FIDUCIARY LAW, *supra* note 4, at 3. See also Field, *supra* note 5, at 744.

⁶¹ ERISA §§ 2-538, 29 U.S.C. §§ 1001-1168 (1998).

⁶² ERISA FIDUCIARY LAW, *supra* note 4.

⁶³ The definition of fiduciary is set forth in ERISA § 3(21), U.S.C. § 1002(2), which states: [A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan

administration of employee benefit plans.⁶⁴ Together, their differing views have created a perplexing guide for those dealing with pension plans.

One of ERISA's main objectives was the creation of fiduciary obligations to guide fiduciaries in the management and administration of pension plans.⁶⁵ Congress emphasized:

It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.⁶⁶

ERISA's fiduciary law is premised on what the Internal Revenue Code refers to as the "exclusive benefit rule."⁶⁷ ERISA § 404(a)(1) states:

[A] fiduciary shall discharge his duties with respect to a plan *solely in the interest of the participants and beneficiaries* and

--

(A) for the *exclusive purpose* of:

(i) providing benefits to participants and their beneficiaries, and

(ii) defraying reasonable expenses of administering the plan;

or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section (405(c)(1)(B)), 1105 (c)(1)(B).

ERISA § 3(21), 29 U.S.C. § 1002(21).

⁶⁴ JOHN H. LANGBEIN & BRUCE A. WOLK, PENSION AND EMPLOYEE BENEFIT LAW 80 (2d ed. 1995) (discussing the division of jurisdiction between the Department of Labor and the Internal Revenue Service as it pertains to the administration of ERISA).

⁶⁵ *Donovan v. Cunningham*, 716 F.2d 1455, 1463 (5th Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984).

⁶⁶ ERISA § 2(b), 29 U.S.C. § 1001(b) (1998). *See also* *Donovan*, 716 F.2d at 1463.

⁶⁷ ERISA § 404(a), 29 U.S.C. § 1104(a); I.R.C. § 401(a)(3) (1998).

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.⁶⁸

Section 404 evidences Congress's intent⁶⁹ to adopt traditional notions of trust law to monitor fiduciary conduct, particularly the duties of care and loyalty which a trustee owes its beneficiary,⁷⁰ and at the same time, to allow for the unique nature

⁶⁸ ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1)(1998) (emphasis added). ESOPS are not held to the strictures of ERISA § 404(a)(1)(C), as they are permitted to invest primarily in employer securities. ERISA § 404(a)(2), 29 U.S.C. § 1104(a)(2)(1998); *See also* ERISA § 407(d)(5)-(6), 29 U.S.C. § 1107(d)(5)-(6).

⁶⁹ S. REP. NO. 93-127, at 29 (1973), *reprinted* in 1 Legislative History 587, 615. *See also* S. REP. NO. 93-127 (1974), *reprinted* in 1974 U.S.C.C.A.N. 4839, 4866; H.R. REP. NO. 93-1280, at 295 (1976), *reprinted* in 3 Legislative History of the Employee Retirement Income Security Act of 1974, 4277, 4562; H.R. REP. NO. 533, 11, 13, *reprinted* in 1974 U.S.C.C.A.N. 4639, 4649, 4651.

⁷⁰ The Eastern District Court of New York described the application of trust principles to fiduciaries with respect to ERISA:

The legislative history of the [fiduciary duty] sections of ERISA indicates, that to the extent practical, the obligations of trustees of pension funds and the limitations on their power of investment were to be interpreted under principles applicable to trustees under the common law of trusts, with a view toward establishing uniform standards.

Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F. Supp. 986, 990 (E.D.N.Y. 1978). *See also* Fischel & Langbein, *supra* note 13, at 1108 ("The duty of prudent investing, the duty to diversify investments, and the duty of prudent administration are familiar standards of trust law."); RESTATEMENT (SECOND) OF TRUSTS § 174 (prudent administration), § 227 (prudent investing), and § 228 (diversification) (1959).

and character of employee benefit plans.⁷¹

The duty of care imposes standards by which courts judge fiduciary decisions and which mandate that a fiduciary perform his or her duties in good faith, in the best interests of the beneficiary, with reasonable care, and on an informed basis.⁷² Encompassing the duty of care is the "business judgment rule." This common law rule, now codified in the Revised Model Business Corporation Act, represents the judicial attitude that courts will abstain from reviewing fiduciary decisions.⁷³ That is, the rule presumes that directors' decisions are honest and well-

⁷¹ ERISA § 3(21), 29 U.S.C. § 1002(21)(1998) (identifying a broader class of fiduciaries); *See also* ERISA §§ 421-431, 29 U.S.C. §§ 1021-31(1998) (requiring stricter reporting and disclosure requirements); ERISA § 406, 29 U.S.C. § 1106 (1998) (prohibited transactions); ERISA §403(c)(1), 29 U.S.C. § 1103(c)(1) (providing that plan assets shall not inure to the benefit of an employer except in explicitly described circumstances).

⁷² *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (articulating the standards of care required of a fiduciary and predicated director liability upon gross negligence). *See also* REVISED MODEL BUS. CORP. ACT § 8.30(a) (West Supp. 1997) (codifying the standards proposed in *Aronson*). REVISED MODEL BUS. CORP. ACT § 8.30(a) establishes the general standard of care for all directors of a corporation. It provides:

A director shall discharge his duties as a director, including his duties as a member of a committee:

- (1) in good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interest of the corporation.

REVISED MODEL BUS. CORP. ACT § 8.30(a).

⁷³ Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 22-23 (1989) (explaining that "[i]n the eyes of most commentators, [the statutory standard of due care] is aspirational and does not provide the test for directorial liability. Rather the liability standard is the so-called business judgment rule, which shields even negligent directors for liability in many circumstances.") *See also* Joseph Hinsey IV, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, The Doctrine, and The Reality*, 52 GEO. WASH. L. REV. 609, 611 (1984) (discussing the absence of judicial review of fiduciary decisions contemporaneous with the absence of liability for those decisions); Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1492-1495 (1984) (noting that "[t]he whole concept of negligence and of 'reasonable man' presupposes as a predicate a clear conception of *what* the person is doing, and a community understanding of a standard of normalcy about *how* he should do it. *Both pieces are missing in the case of the work of corporate directors.*"); AMERICAN LAW INST. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994) (viewing the business judgment rule as a safe harbor to director liability).

intended, rational, and informed.⁷⁴

Like the duty of care, the duty of loyalty is a significant standard governing fiduciary conduct.⁷⁵ The duty of loyalty arises when a director acts on both sides of a transaction.⁷⁶ The duty of loyalty requires that directors put the interests of the corporation above their own.⁷⁷ When a fiduciary's duty of loyalty is questioned, courts invoke the "entire fairness" test, which requires the fiduciary to demonstrate the entire fairness of the transaction.⁷⁸ If a majority of disinterested directors approve the fiduciary's transaction, the challenging party has the burden of proving that the fiduciary engaged in unfair dealing at an unfair price.⁷⁹ Otherwise, the fiduciary has the burden of proving the transaction was fair.⁸⁰

In addition to the fiduciary duties delineated in ERISA § 404(a) and those basic duties espoused by traditional trust law, ERISA § 406 imposes a list of prohibited transactions.⁸¹ Engaging in these transactions is a *per se* violation of

⁷⁴ AMERICAN LAW INST. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01 (1994).

⁷⁵ REVISED MODEL BUS. CORP. ACT, Subchapter F, section 8.60-8.63 (amending RMBCA § 8.31 to provide a bright-line test for judgment self-dealing transactions).

⁷⁶ *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921). In *Geddes*, the United States Supreme Court reviewed a transaction involving a director of a corporation and the buying and selling of corporate property for inadequate consideration. The Court stated:

The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character. This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add in the soundest business policy.

Id. at 599.

⁷⁷ *Id.* See also RESTATEMENT (SECOND) OF TRUSTS § 170(1) (stating that the duty of loyalty requires "the trustee . . . to administer the trust solely in the interest of the beneficiary"). Cf. ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (1998) (requiring that a fiduciary act "solely in the interest of the beneficiaries and . . . for the exclusive purpose of . . . providing benefits to the participants and their beneficiaries").

⁷⁸ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983), *on remand to*, *Weinberger v. UOP, Inc.*, 1985 WL11546, (Del. Ch. 1985)(No. 5642). *aff'd*, 497 A.2d 792 (Del. 1985).

⁷⁹ *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985).

⁸⁰ *Id.*

⁸¹ ERISA § 406, 29 U.S.C. § 1106 (1998). Section 406(1106) provides:

ERISA.⁸² However, ERISA exempts ESOP fiduciaries from the strictures of these rules.⁸³ ESOP fiduciaries may conduct otherwise prohibited transactions by

(a) Except as provided in section (408)(1108):

(1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect-

(A) sale or exchange, or leasing, or any property between the plan and a party in interest;

(B) lending of money or other extension of credit between the plan and a party in interest;

(C) furnishing of goods, services, or facilities between the plan and a party in interest;

(D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or

(E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section [407(a)](1107(a)) . . .

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section [407(a)](1107(a)) . . .

(b) A fiduciary with respect to a plan shall not --

(1) deal with the assets of the plan in his own interest or for his own account,

(2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or

(3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

ERISA § 406; 29 U.S.C § 1106.

⁸² *Cutaiar v. Marshall*, 590 F.2d. 523, 529 (3d Cir. 1979).

⁸³ ERISA § 408(e), 29 U.S.C. § 1108(e)(1998) (exempting ESOPs from the prohibited transactions dealing with the acquisition of employer securities). Section 408(e) states:

(e) Sections [406](1106) and [407](1107) shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section [407(d)(5)](1107)(d)(5)) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section [407(d)(4)] 1107(d)(4))--

(1) if such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligations, at a price not less factorable to the plan than the price determined under section [407(e)(1)] (1107 (e)(1)),

acquiring employer securities, provided those securities are purchased for "adequate consideration."⁸⁴ The fiduciary duties imposed by ERISA challenge ESOP fiduciaries. Although ERISA gives ESOP fiduciaries more flexibility than non-ESOP fiduciaries or trustees, their actions are nevertheless, carefully scrutinized for compliance with ERISA.⁸⁵ Fiduciaries of defensive ESOPs⁸⁶ encounter more difficult decisions, as they must determine how to vote unallocated shares and must decide to what extent, if any, to favor management. Often, these fiduciaries play dual roles as both an ESOP fiduciary and as an officer or director of the corporation

(2) if no commission is charged with respect thereto, and

(3) If --

(A) the plan is an eligible individual account plan (as defined in section [407(e)(3)]) (1107(e)(3)), or

(B) in the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition or qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section [407(a)] (1107(a)).

⁸⁴ ERISA § 3(18), 29 U.S.C. § 1002(18) which provides:

The term "adequate consideration" when used in part 4 of subtitle B means (A) in the case of a security for which there is a generally recognized market, either (i) the price of the security prevailing on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, or (ii) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issues and of any party in interest; and (B) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

⁸⁵ CANAN, *supra* note 31, at 159 (discussing the duties of ESOP trustees). *See also* H.R. REP. NO. 93-1280, at 133-34 (1974), *reprinted* in 1974 U.S.C.C.A.N. 5038, 5186.

⁸⁶ Defensive ESOPs are ESOPs created as defensive measures in takeover contests. This technique puts large amounts of stock in the friendly hands of corporate shareholders (i.e., ESOP plan participants). ERISA FIDUCIARY LAW, *supra* note 4, at 30. *See generally*, Donovan v. Bierwirth, 538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd in part, modified in part*, 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982) (setting forth standards to govern ESOPs established in takeover contests). In the late 1980's, ESOPs were extensively created to thwart corporate takeovers. ERISA FIDUCIARY LAW, *supra* note 4, at 33, n.141. The following companies transferred massive amounts of stocks to ESOPs in 1989: "Proctor and Gamble, Texaco, J.C. Penney, May Co., Melville Corp., Xerox Corp., McDonalds Corp., Colgate-Palmolive, The Travelers Corp., United Technologies, Delta Airlines, Southwestern Bell, Sara Lee Corp., and Boise Cascade." *Id.*

sponsoring the qualified plan.⁸⁷ This type of "dual motive" situation spurs conflicts of interest, and the use of an independent fiduciary is often warranted.⁸⁸

III. SPECIAL FIDUCIARY ISSUES

ESOP fiduciaries face a whirlwind of potential conflicts in fulfilling their fiduciary obligations under ERISA. Most of these conflicts arise in the context of corporate takeover contests and center around how shares of stock are voted, which "hat" an employer-fiduciary is donning, and whether an ESOP fiduciary prudently disposed of employer securities. That is, whether a decision at odds with the plan document is nevertheless prudent, and whether securities were sold or acquired for "adequate consideration." These are just a few issues over which the courts and the legislatures have struggled and which have left fiduciaries wondering how to properly execute their fiduciary duties without violating ERISA. This article will explore in detail two of those issues. First, it will examine the conflicts attending the voting rights of allocated and unallocated shares of ESOP stock. Second, it will address the problematic use of ESOPs to thwart hostile corporate takeovers.

A. Voting and Tendering ESOP Stock

The increase of ESOPs has spawned a heightened interest in how ESOP stock is voted.⁸⁹ The ESOP fiduciary confronts two main dilemmas with respect to the voting of ESOP stock; one regarding pass-through or directed voting, and a second dealing with mirrored or proportional voting.⁹⁰ By definition, ESOPs are stock bonus plans, and therefore, must meet the requirements of Internal Revenue Code § 401(a), in addition to the requirements set forth in I.R.C. § 4975(e)(7).⁹¹ I.R.C. § 401(a)(22) requires that stock bonus plans, including ESOPs, meet the pass-

⁸⁷ CANAN, *supra* note 31, at 159.

⁸⁸ *Id.* See also Fischel & Langbein, *supra* note 13, at 1156-57, who stress:

The severe conflicts of interest that frequently arise when the ESOP trustees are representatives of management further highlight the tension between ESOPs and the exclusive benefit rule. In leveraged buy-outs involving ESOPs . . . the ESOP trustees must decide how much the ESOP should pay for the employer stock. Since the trustees typically represent (or are themselves) selling shareholders, the conflict of interest is intense.

⁸⁹ O'Toole, *supra* note 5, at 826-828 (writing about the battles surrounding the right to vote ESOP stock).

⁹⁰ ERISA FIDUCIARY LAW, *supra* note 4, at 204-08 (discussing the statutory voting rights of shareholders).

⁹¹ See *supra* note 3 and accompanying text.

through voting strictures of I.R.C. § 409(e) if the qualified plan has stock which is not readily tradeable on the open market and which has invested in excess of 10% of its assets in employer securities.⁹² Moreover, I.R.C. § 409(e)(5) allows each participant one vote, with the trustee voting these allocated shares in proportion to those votes.⁹³ Comparatively, if the ESOP holds registration-type securities,⁹⁴ participants may vote their allocated shares on *all* matters requiring a shareholder vote.⁹⁵

1. Duties of the Directed Trustee in Voting Allocated Shares

Voting directed allocated shares is the least problematic voting issue for ESOP fiduciaries, as I.R.C. § 409(e) sets forth the parameters for voting these shares. Nonetheless, fiduciaries do struggle somewhat in this area. The legislature has failed to address the tension between the expansive fiduciary duties of ERISA § 404(a)(1) and the confined duties of the directed trustee⁹⁶ prescribed in ERISA § 403(a).⁹⁷ This lack of explanation has caused the Department of Labor and the courts to interpret ERISA § 403(a) differently, and consequently, to weigh fiduciary

⁹² I.R.C. § 409(e) mandates the participants' right to:

[D]irect the plan as to the manner in which voting rights under securities of the employer which are allocated to the account of such participant or beneficiary are to be exercised with respect to any corporate matter which involves the voting of such shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations.

I.R.C. § 409(e)(3) (allowing votes only on major corporate decisions which does not include tender offers).

⁹³ I.R.C. § 409(e)(5)(A), (B).

⁹⁴ I.R.C. § 409(e)(4), Securities Exchange Act of 1934 § 12 (those securities which a corporation must register pursuant to § 12 of the Securities Exchange Act of 1934 are often referred to as "Section 12 securities").

⁹⁵ I.R.C. § 409(e)(2).

⁹⁶ A directed trustee is a trustee with limited authority to follow the directions of a "named fiduciary" who makes certain decisions regarding plan assets pursuant to ERISA § 403(a)(1). *Reich v. Nations Bank of Georgia, N.A.*, 19 E.B.C. (BNA) 1345, 1995 WL 316550 (N.D. Ga. 1995), *amended* 1995 WL 389614 (1995), *rev'd sub nom. Herman v. Nations Bank Trust Co.*, 129 F.3d 1354 (11th Cir. 1997), *reh'g denied*, 135 F.3d 1909 (11th Cir. 1998). *Cert. denied*, 119 S. Ct. 54 (1998).

⁹⁷ Colleen E. Medill, *The Law of Directed Trustee Under ERISA: A Proposed Blueprint for the Federal Courts*, 61 MO. L. REV. 825, 831 (1996) (noting the difference in judicial opinion on the duties of the directed trustee).

conduct against varied standards.⁹⁸

ERISA § 403(a) states:

[T]he trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that--

(1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this Act, or

(2) authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 402(c)(3).⁹⁹

When a plan participant directs a trustee on how to vote his or her allocated shares, the plan participant is considered a "named fiduciary"¹⁰⁰ for such limited purpose.¹⁰¹ The Department of Labor has noted that this pass-through procedure may be followed if the named fiduciary's directions do not violate ERISA or conflict with the plan terms, and provided that a fiduciary follow guidelines to ensure that a participant's vote is cast independently and without coercion.¹⁰² Such guidelines include providing a participant with adequate information about the matter on which he or she is to vote, withholding from a participant any information which is likely to be misleading, allowing a participant sufficient time to render a decision, inquiring as to delayed responses, and assuring full confidentiality of a participant's decision.¹⁰³

⁹⁸ *Id.* at 833 (recognizing that "[t]he root of the problem . . . no guidance in the statute as to what constitutes a 'proper' direction . . . [N]o guidance . . . concerning to what lengths the directed trustee must go to ascertain whether the direction is in accordance with the terms of the plan and ERISA.").

⁹⁹ ERISA § 403(a)(1)-(2), 29 U.S.C. 1103(a)(1)-(2) (1998).

¹⁰⁰ ERISA § 402(a)(2), § 1102(a)(2).

¹⁰¹ *DOL Opinion Letter on Tender Offers*, 16 Pens. Rep. (BNA) 390 (Feb.23, 1989).

¹⁰² *Id.* See also *DOL Advisory Opinion on Fiduciary Responsibility in Connection with Attempted Corporate Takeovers*, 11 Pens. Rep. (BNA) 633 (Apr. 30, 1984).

¹⁰³ John S. Welsh, *Fiduciary Aspects of Employee Stock Ownership Plan Investments in Employer Securities*, 23 REAL PROP. PROB. & TR. J. 575, 594-95 (1988) (discussing the Department of Labor's suggested safeguards to assist fiduciaries with pass-through voting).

Early case law which reviewed the duties of directed trustees introduced several fundamental principles.¹⁰⁴ First, the cases recognized that directed trustees were fiduciaries under ERISA, and subject to ERISA fiduciary law.¹⁰⁵ Second, where a plan fiduciary gave a direction, the directed trustee could accept that direction without further inquiry provided the direction facially complied with the plan terms, and did not violate ERISA.¹⁰⁶ That is, the specific duties of ERISA § 403(a) override those general duties outlined in ERISA § 404(a).¹⁰⁷

Recent case law has confused the fundamental policies which the early cases have established. The court in *FirsTier Bank, N.A. v. Zeller*,¹⁰⁸ imposed the duty of independent inquiry upon a directed trustee when given a direction by another fiduciary, but not when a trust beneficiary gave such direction.¹⁰⁹ This strict application of common trust law not only skews ERISA's functional scheme in the delegation of duties among fiduciaries, but it removes the extra protection which most plan participants need.¹¹⁰

Elevating the confusion is the Eighth Circuit Court of Appeals division in *Manice v. Commerce Bank*,¹¹¹ which reviewed the conduct of a directed trustee after receiving directions from an ESOP committee regarding the acquisition and sale of the employer's securities.¹¹² Ignoring ERISA § 3(21)(A)(i), which discusses fiduciary duties involving the management and disposition of plan assets, the court determined that the directed trustee was not a fiduciary under ERISA § 3(21)(A)(i),

See also DOL Information Letter, 22 Pen. & Ben. Rep. (BNA) 2249 (Sept. 28, 1995).

¹⁰⁴ Medill, *supra* note 97, at 840. *See also* Newton v. Van Otterloo, 756 F. Supp. 1121, 1132-33 (N.D. Ind. 1991); Ershick v. United Missouri Bank, 948 F.2d 660, 667-68 (10th Cir. 1991).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *FirsTier Bank, N.A. v. Zeller*, 16 F.3d 907 (8th Cir. 1994), *reh.g., en banc, denied*, 1994 U.S. App. Lexis 7817 (8th Cir. Apr. 18, 1994), *cert. denied sub nom.*, *Vencoc v. FirsTier Bank, N.A.*, 513 U.S. 871 (1994).

¹⁰⁹ *Id.* at 911 (explaining that "an ERISA trustee who deals with plan assets in accordance with proper directions of another fiduciary is not relieved of its fiduciary duties to conform to the prudent man standard of care. . . .")

¹¹⁰ Medill, *supra* note 97, at 847 (stating that "[s]uch a rule provides no protection to the plan participants in situations where they are potentially vulnerable to coercion by their employer who sponsors the plan. This danger is particularly acute when the plan holds as an asset shares of company stock.").

¹¹¹ *Manice v. Commerce Bank*, 40 F.3d 264 (8th Cir. 1994), *reh'g, en banc, denied*, 1994 U.S. App. Lexis 36045 (8th Cir. Dec. 19, 1994), *cert. denied*, 514 U.S. 1111 (1995).

¹¹² *Id.* at 265-66.

as it exercised no discretion as to the sale or purchase of the stock.¹¹³ The effect of this decision is to place significant burdens on plan participants who are injured as a result of the conduct of a directed trustee and to leave them without a remedy.¹¹⁴

The case law discussed above and the Department of Labor's interpretation of directed trustees' duties under ERISA suggest that ERISA § 403(a)(1) has two possible meanings.¹¹⁵ Earlier case law suggested that the phrase "proper directions," incident to § 403(a)(1), means that a directed trustee may passively follow a direction of a plan fiduciary if that direction, on its face, complies with ERISA.¹¹⁶ However, more recent case law, particularly *FirstTier Bank*, emphasized that a direction given by another fiduciary is proper only if the directed trustee independently inquires of and investigates the direction to ensure that his or her ultimate decision to follow such direction comports with ERISA fiduciary law.¹¹⁷ Contrarily, *FirstTier* suggests that when a direction is given by a plan participant, the directed trustee need not independently review the decision.¹¹⁸

This article is primarily concerned with a directed trustee's duty in relation to a plan participant. Unlike the Eighth Circuit's approach in *FirstTier Bank*, the Department of Labor finds a directed trustee's duty of independent inquiry imperative in the context of participant-directed voting.¹¹⁹ Unfortunately, the

¹¹³ *Id.* at 267. *But see, e.g.*, H.R. CONF. REP. NO. 93-1280 (1973), reprinted in 1974 U.S.C.C.A.N. 5038, 5075, 5079, 5082-83 (writing about the duties of directed trustees and their fiduciary responsibilities); *FirstTier Bank* 16 F.3d at 911(holding that the directed trustee was a fiduciary under ERISA § 3(21)(A)(i)). The court noted that "[T]his section imposes fiduciary duties not only if one exercises discretionary authority or control over plan management, but imposes those duties whenever one deals with plan assets." *Id.*

¹¹⁴ Medill, *supra* note 97, at 846 (discussing the effect of defining the directed trustee as a nonfiduciary).

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 851-852. *See also* Newton v. Van Otterloo, 756 F. Supp. at 1132-33; Ershick v. United Missouri Bank, 948 F.2d at 667-68.

¹¹⁷ *FirstTier Bank*, 16 F.3d at 911.

¹¹⁸ *Id.* *But see, e.g.*, Danaher Corp. v. Chicago Pneumatic Tool Co., 635 F. Supp. 246, 249 (S.D.N.Y. 1986) (expressing a belief that "it would be inappropriate (and perhaps a breach of fiduciary obligation) for a trustee to put aside his personal judgment in favor of carrying out the wishes of the CP plan participants."); Martin v. NationsBank of Georgia, N.A., 16 E.B.C. (BNA) 2138, 1993 WL 345606 (N.D. Ga. 1993) (stressing that it is inappropriate for a trustee to follow a participant's direction where merely following that direction conflicts with the trustees' fiduciary duties under ERISA).

¹¹⁹ DOL Information Letter, 22 Pen. & Ben. Rep. (BNA) 2249 (Sept. 28, 1995). *See also* DOL Letter re: Profit Sharing Plan for Employees of Carter Hawley Hal Stores, Inc. 11 Pens. & Ben. Rep. (BNA) 633 (April 30, 1984) [hereinafter *Carter Hawley Letter*]

Department of Labor does not approach participant-directed loans as it does participant-directed voting, which adds even more confusion to this area of the law.¹²⁰ With respect to participant-directed votes, the Department of Labor has adopted a position similar to the earlier case law discussed above, which imposes a duty of independent inquiry on a directed trustee only if the directed trustee had actual knowledge of coercion or if the decision on its face is contrary to ERISA.¹²¹ As for the participant-directed investments, the Department of Labor has taken the middle ground, and looks to whether the participant exercised independent control in choosing the investment, but fails to suggest that the directed trustee has a duty of inquiry to determine if the participant's decision was truly independent.¹²²

The federal courts and the Department of Labor have established inconsistent standards to guide directed trustees. Most likely, their purpose in developing these standards was to safeguard the rights of plan participants without violating ERISA. However, these purposes are ill-served because of their inconsistency. The federal courts have strictly applied standards of trust law,¹²³ while the Department of Labor applies a facts and circumstances test, looking to the type of direction which the participant is giving, and specifying a standard based on

(emphasizing the necessity for safeguarding a plan participant's right to independently vote his or her shares); CANAN, *supra* note 31, at 134 n.6 ([P]ass-through voting for allocated shares permissible as long as plan trustee ensures that participants have made a proper decision under ERISA, i.e., that necessary information was provided to participants, that clearly false or misleading information was not distributed to participants, and that the participants were not subjected to pressure from the employer to vote their shares in a particular manner. . . .); Medill, *supra* note 97, at 856-57, wherein, Medill states:

[U]nder the common law of trusts, the directed trustee was not required to independently investigate a facially valid direction made by a trust beneficiary solely for his own behalf. In the context of an ESOP with participant-directed voting, each participant directs the trustees solely with respect to the shares held in his own ESOP account, a situation similar to where a trust beneficiary directs the trustee solely for his own benefit. Therefore, under a strict application of the common law of trusts, the directed trustee of the ESOP would not be required to look behind the facially valid voting directions of the ESOP participants to determine the fairness of the voting procedures.

Id.

¹²⁰ 29 C.F.R. § 2550.408b-1(a)(4), Example (3) (1995).

¹²¹ *Id.*

¹²² 29 C.F.R. § 2550.404c-1(c)(2).

¹²³ *FirsTier Bank*, 16 F.3d at 911.

that particular direction.¹²⁴ If a directed trustee accepts a participant-directed vote which is facially valid without further inquiry, under federal law, the trustee has not violated his or her ERISA duties. However, under the Department of Labor's standard, the directed trustee has violated ERISA, as he or she has failed to perform an independent inquiry of the participant's direction.

Unfortunately, legislative history provides little guidance for resolving this conflict.¹²⁵ A simple answer would be to refashion the standards devised by the Department of Labor. Eliminating a facts and circumstances test and applying a clear, bright-line standard to *all* participant-directed issues, whether they concern voting, investments, or loans, would provide directed trustees with greater guidance in their affairs.¹²⁶ Although this added responsibility would be more costly to administer, the lack of ambiguity for trustees coupled with the safeguards it provides to plan participants, far outweigh the added administrative costs.¹²⁷

2. Voting Unallocated Shares

Normally, leveraged ESOPs allocate only a small amount of their purchased stock to their participants.¹²⁸ The additional shares are placed in a suspense account and allocated to participants as the ESOP repays its loan.¹²⁹ Commonly, ESOP plan documents provide for "mirrored voting."¹³⁰ That is, they allow trustees

¹²⁴ 29 C.F.R. § 2550.408b-1(a)(4), Example (3) (1995); § 2550.404c-1(c)(2).

¹²⁵ H.R. CONF. REP. NO. 93-1280 (1973), *reprinted* in 1974 U.S.C.C.A.N. 5038, 5082-83 (discussing the duties of the directed trustee with respect to directions by plan fiduciaries, but failing to discuss participant-directed issues).

¹²⁶ *But see* Medill, *supra* note 97, at 864 (stating that "[i]n other situations, such as participant-directed plan loans or participant-directed investments, the elaborate procedures governing the participant's directions under ERISA arguably provide sufficient protection to the participants so that imposing a duty of independent inquiry upon the directed trustee is unnecessary.").

¹²⁷ In *Varity Corp. v. Howe*, the Supreme Court indicated that employee benefit plans which are costly to administer may deter an employer from implementing such plans. *Howe*, 516 U.S. 489, 494 (1996). Although this is true, blurred fiduciary standards likely will discourage individuals from becoming plan fiduciaries for fear of liability with each decision that they make.

¹²⁸ CANAN, *supra* note 31, at 134.

¹²⁹ *Id.*

¹³⁰ O'Toole, *supra* note 5, at 828 (describing four ways that unallocated shares may be apportioned: (1) the trustee can independently vote or tender the unallocated shares; (2) a committee may vote or tender the unallocated shares; (3) the trustee can vote or tender the unallocated shares proportionate to participants votes on allocated shares; or (4) participants can specifically direct their vote on both their allocated and a proportion of the unallocated

to vote unallocated shares and nonvoted allocated shares in proportion to how the participants voted their allocated shares.¹³¹ Leveraged ESOPs, which require mirrored voting, are great tools to defend against corporate takeovers, for they put large blocks of stocks in corporate friendly hands.¹³² Nonetheless, mirrored voting has sparked controversy between the courts and the Department of Labor, as both have questioned whether mirrored voting violates the fiduciary principles of ERISA.¹³³

The Department of Labor has expressed reservations about mirrored voting.¹³⁴ Its view is that a trustee has a duty to exercise his or her discretion on how unallocated shares are voted, and therefore, must independently vote those shares unless he or she finds that mirrored voting would be prudent under the particular circumstances.¹³⁵ The Department of Labor has opined that voting with

shares).

¹³¹ Grannis, *supra* note 13, at 863-64 (writing about the necessity of a mirrored voting provision in an ESOP plan so as not to interfere with the protection afforded by the Delaware takeover statute). Grannis discusses the importance of the Delaware takeover statute, codified DEL. CODE ANN. tit. 8, § 403, explaining:

This law prohibits a prospective acquiror of a corporation from engaging in any business combination with the target corporation for three years after becoming an 'interested shareholder' (a party owning at least fifteen percent of the stock) unless the acquiror obtains at least eighty-five percent of the voting stock of the target company in the same transaction that causes it to become an interested shareholder. This provision can increase the difficulty of mounting a takeover. An acquiror cannot 'creep' beyond fifteen percent and therefore must acquire at least seventy percent of the company at the premium price of the tender offer. But in order for the shares in the ESOP to be considered 'outstanding,' employees must have the 'right to determine confidentially whether shares held subject to the plan will be tendered.' Mirrored voting provisions provide this right and thus fulfill the statute's requirements.

Id.

¹³² *Id.* See also Letter from Alan Lebowitz, U.S. Dep't of Labor, Office of Pension and Welfare Benefits Program, to the Securities and Exchange Commission (Jan. 30, 1985) (writing about the proposed ESOP of Phillips Petroleum to ward off T. Boone Pickens's takeover threat).

¹³³ *Id.* See also Grannis, *supra* note 13, at 864 n.91 (stating that "the Department of Labor has opined that ERISA requires the ESOP trustee to make an independent fiduciary decision as to how the unallocated shares should be voted and tendered. . . This creates a conflict between the requirements of the Delaware anti-takeover law and federal regulations that has not been resolved.").

¹³⁴ CANAN, *supra* note 31, at 135.

¹³⁵ Carter Hawley Letter, *supra* note 119. See also Letter from Alan Lebowitz, Deputy

respect to unallocated shares is the "exclusive responsibility of the Plan trustee" and that this duty overrides any plan provisions requiring mirrored voting.¹³⁶ Furthermore, the Department of Labor acknowledged that plan assets include the right to vote stock, thus, dictating that as part of a trustee's duty to manage plan assets, the trustee must vote unallocated stock.¹³⁷

One court has expressed a view similar to the Department of Labor with regard to mirrored voting. In *Danaher Corporation v. Chicago Pneumatic Tool Company*,¹³⁸ the court reviewed whether it was permissible for a company to transfer one million shares of stock to its ESOP and then allow the trustee to vote the unallocated shares in proportion to the allocated votes of the participant-employees.¹³⁹ Chicago Pneumatic argued that the trustee had a duty to protect the employees of the corporation, and the best way to do this was to allow the trustee to utilize the proportional voting provision of the benefit plan.¹⁴⁰ The court rejected this argument and held:

It therefore appears that the trustees must discharge their duties by evaluating the best interests of beneficiaries in the abstract as beneficiaries. The duty cannot be discharged simply by consulting and carrying out the expressed wishes of those whose present position makes them the presumptive beneficiaries. To do so would be as inappropriate as voting in deference to the expressed wishes of those Danaher employees who are likely to succeed to participating positions if Danaher's takeover attempt succeeds.¹⁴¹

The court reasoned that the participants had no vested right to participate in future allocations, as their participant status was contingent on their employment, and that present participants had no right to vote on issues which would benefit future beneficiaries.¹⁴²

Assistant Secretary for Program Operations, DOL, to ESOP Trustee (Feb. 23, 1989), reprinted in 16 Pens. Rep. (BNA) No. 9, 391 (Mar. 6, 1989).

¹³⁶ *Id.*

¹³⁷ *Id.* See also 29 C.F.R. § 2510.3-101 (1989).

¹³⁸ *Danaher Corporation v. Chicago Pneumatic Tool Company*, 635 F. Supp. 246, 249 (1986).

¹³⁹ *Id.* at 247, 249.

¹⁴⁰ *Id.* at 249 (In a letter to the court, the company urged, "[I]t is legal under ERISA . . . to pass the vote through directly to the employees . . . there is no more representative group than the present employees of the interests of all CP employees, present and future.").

¹⁴¹ *Id.* at 250.

¹⁴² *Id.* at 249-50.

A year later, the court for the Southern District of New York espoused a different view regarding mirrored voting. In *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*,¹⁴³ a target corporation transferred a large block of stock to its ESOP in an attempt to thwart a corporate takeover. The court reviewed whether the trustee could proportionally vote the unallocated shares and summarily held that he could, provided he acted in the best interests of the ESOP beneficiaries.¹⁴⁴

Two distinct and contradicting views exist concerning the appropriate standard for ESOP trustees when voting unallocated shares of employer stock. The issue remains unresolved, although the Department of Labor has retreated somewhat from its firm position against mirrored voting.¹⁴⁵ The Department of Labor has issued two letters which suggest that it is appropriate for a trustee to proportionally vote unallocated shares.¹⁴⁶ In a 1989 letter, the Department of Labor opined that a trustee could follow a mirrored voting provision if it was prudent and in the best interests of the plan participants.¹⁴⁷ Subsequently, in a 1995 letter, the Department of Labor curtailed its position even further, noting that a trustee *should* follow a plan document specifying proportional voting, unless doing so would be imprudent.¹⁴⁸ Thus, it appears that the Department of Labor has taken a lenient approach to mirrored voting, similar to the court in *British Printing*.

¹⁴³ *British Printing & Communication Corp. v. Harcourt Brace Jovanovich, Inc.*, 664 F. Supp. 1519 (S.D.N.Y. 1987).

¹⁴⁴ *Id.* at 1528-29.

¹⁴⁵ CANAN, *supra* note 31, at 135.

¹⁴⁶ *DOL Opinion Letter on Tender Offers*, February 23, 1989, reprinted in, 16 Pen. Rep. (BNA) 390 (March 6, 1989) [hereinafter *Polaroid Letter*]; *DOL Information Letter re: Pass-through Voting Provisions in Collectively Bargained Employee Stock Ownership Plans, to Ian D. Lanoff on behalf of AFL-CIO*, (September 29, 1995) [hereinafter *AFL-CIO Letter*].

¹⁴⁷ *Polaroid Letter* in which the Department of Labor stated:

[T]o the extent, however, that those Plan provisions instruct the trustee . . . concerning the method by which he shall tender . . . unallocated or non-voted allocated stock . . . the Plan trustee may follow such Plan provisions only to the extent . . . consistent with the provisions of title I and IV of ERISA. Thus . . . Plan trustees, must determine, among other things, whether following such provisions would be prudent for the plan and would produce a result which would be for the exclusive purpose of providing benefits to the plan participants and beneficiaries.

Polaroid Letter, *supra* note 146.

¹⁴⁸ *AFL-CIO Letter*, *supra* note 146 (noting that a trustee may not ignore a Plan's pass-through voting provisions, and in doing so, has the burden to show that following them would be imprudent).

Notwithstanding the Department of Labor's position, in 1995, the Northern District Court of Georgia issued an opinion which implied that mirrored voting was impermissible and contrary to ERISA.¹⁴⁹ In *Reich v. NationsBank of Georgia*, the issue concerned the standard of care owed participants with respect to the tender of unallocated and nonvoted shares.¹⁵⁰ The case arose in the shadow of a takeover contest between Polaroid Corporation and Shamrock Acquisitions III, Inc..

In 1988, Polaroid Corporation ("Polaroid") established a partially leveraged ESOP, appointing NationsBank as the ESOP trustee.¹⁵¹ The ESOP purchased 300 million shares of stock from Polaroid, allocating approximately 15 million shares to the participants' individual accounts.¹⁵² Over 90% of the ESOP shares remained unallocated.¹⁵³ The Polaroid Employee Stock Equity Plan (the "Plan") delineated three provisions to govern the ESOP in the event of a tender offer. The first was a pass-through provision which provided that participants could direct the trustee in tendering their allocated stock. Second, the Plan incorporated an instruction provision which required participants to specifically direct their allocated shares in order for the trustee to tender them. Finally, the Plan had a mirrored provision which permitted the trustee to tender unallocated shares in proportion to allocated shares.¹⁵⁴

Soon after Polaroid established its ESOP, Shamrock Acquisitions III, Inc. ("Shamrock") filed suit to enjoin the ESOP and asked to negotiate the acquisition of Polaroid.¹⁵⁵ Polaroid rejected, and Shamrock initiated a tender offer, offering forty-five dollars per share for Polaroid's stock.¹⁵⁶ In response, Polaroid commenced a self-tender, offering fifty dollars per share for its stock.¹⁵⁷ The trustee tendered only the participant-directed allocated shares to Polaroid, leaving the other unallocated and nonvoted shares untouched.¹⁵⁸ The United States Secretary of Labor brought suit against the ESOP trustee claiming that it violated its ERISA fiduciary

¹⁴⁹ *Reich v. NationsBank of Georgia, N.A.*, 19 E.B.C. (BNA) 1345, 1995 WL 316550 (N.D. Ga. 1995), *amended* 1995 WL 389614 (1995), *rev'd sub nom. Herman v. Nations Bank Trust Co.*, 129 F.3d 1354 (11th Cir. 1997) *reh'g denied*, 135 F.3d 1409 (11th Cir. 1998) *cert. denied*, 119 S. Ct. 54 (1998).

¹⁵⁰ *Id.* at *8.

¹⁵¹ *Id.* at *1.

¹⁵² *Id.* at *1-2.

¹⁵³ *Id.*

¹⁵⁴ *Reich*, 1995 WL 316550 at *2.

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* at *3.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

duties of prudence and loyalty under § 404(a)(1)(A) and (B).¹⁵⁹

The court held that trustees must act prudently and in the best interests of the participants and their beneficiaries.¹⁶⁰ The court relied on *Danaher*, stating:

[A]lthough the opinion in *Danaher* is dicta, the court made a well-reasoned analysis . . . Although ERISA § 403(a) expressly provides that a trustee is subject to the direction of a 'named fiduciary,' this can only occur when it is not contrary to ERISA. In this court's view, allowing present participants, who have an immediate conflict of interest, to act as 'named fiduciaries' of unallocated shares is contrary to ERISA. There is simply no way to ensure that present participants will make tender decisions that are in the best interests of all participants who will benefit from the plan in the future, without requiring a trustee to exercise independent judgment.¹⁶¹

Moreover, the court reasoned that I.R.C. § 409(e) requires that a court sanction only pass-through voting on allocated shares held by ESOPs of publicly held corporations.¹⁶² The court emphasized that because I.R.C. § 409(e)(5) makes no distinction between allocated and unallocated shares, the court can reasonably infer that Congress intended I.R.C. § 409(e) to apply only to allocated shares, which are referenced in I.R.C. § 409(e)(2) and (3).¹⁶³

The earlier opinions of the Department of Labor and the decisions of the *Danaher* and *Reich* courts present strong arguments against mirrored voting provisions in ESOP plans.¹⁶⁴ The best solution to untangling the divergent views

¹⁵⁹ Reich, 1995 WL 316550 at *4-5.

¹⁶⁰ *Id.* at *13.

¹⁶¹ *Id.* at *16.

¹⁶² *Id.*

¹⁶³ *Id.* at *17. The court noted, "[I]t would appear that Congress has only recognized and approved mirrored voting provisions in certain circumstances. These circumstances are when an ESOP: 1) falls under Section 409(e)(3), where the employer does not have a registration-type class of securities, and 2) provides for apportioning its votes on a one person, one vote basis." *Id.*

¹⁶⁴ But see O'Toole, *supra* note 5, at 844. O'Toole notes:

[M]any practitioners claim that Congress's primary purpose in favoring ESOPs was to create tools of corporate finance, which simultaneously broadened capital ownership for employees by allowing them to have input in shareholder decisions. Consequently,

of the Department of Labor and of the courts is to implement a bright-line standard requiring that fiduciaries independently inquire into votes on *all* shares, allocated or unallocated. This standard would protect fiduciaries, regardless of whether they had exclusive authority to manage the plan assets or had to follow the directions of a "named fiduciary." This standard of care would accomplish numerous objectives.

First, it would assure that plan participants are protected, in that fiduciaries would be required to evaluate whether a participant has independently voted his or her allocated shares or whether that participant has been coerced and/or misinformed, and therefore, has compromised his or her vote to the whim of management.¹⁶⁵ Second, it would more effectively guide fiduciaries in their duties to exclusively benefit plan participants and their beneficiaries.¹⁶⁶ No longer would fiduciaries be subjected to diverse standards based on whether the shares tendered were allocated, or unallocated. One clear standard would govern all fiduciaries, making it easier for them to perform their jobs and to determine the best interests of both present participants and future beneficiaries.¹⁶⁷ Moreover, a clear standard would provide incentives for individuals to act as fiduciaries without the constant fear of liability. In effect, this would allow fiduciaries to administer ESOPs and manage plan assets more efficiently and would benefit all involved.¹⁶⁸

Rather than issue periodic letters which continuously undermine its position on voting, the Department of Labor should implement a regulation which establishes firm safeguards across the board to guide *all* fiduciaries on *all* matters of voting. This would ensure that *all* fiduciaries understand that they have a

they argue that not allowing participants to vote unallocated shares in proportion to their allocated shares severely limits this purpose.

Id.

¹⁶⁵ O'Toole writes, "[t]he proportional voting provision violates ERISA because it permits self-dealing and imprudent administration of plan assets, actions that are not in the sole interests of participants and beneficiaries." *Id.* at 851.

¹⁶⁶ *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981) *order modified* by 680 F.2d 263 (2nd Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982) (explaining that "although a trustee may have dual loyalties, when acting on behalf of the fund, his primary loyalty to the fund is the only loyalty which may affect his judgment.").

¹⁶⁷ *Danaher*, 635 F. Supp. at 250 (1986) (stressing that present participants have no interest in benefitting those other than themselves, and thus, should not vote on issues benefitting future participants).

¹⁶⁸ *But see* O'Toole, *supra* note 5, at 865 n.210. "It is also true that requiring a trustee's independent voting may generate some additional costs ('inefficiencies') . . . Of course a trustee will probably raise the fees that it charges to administer the plan. These extra fees surely will be paid out of . . . the pockets of the plan participants and beneficiaries." *Id.* Cf. Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

heightened duty of care, that of the prudent expert pursuant to ERISA §404(a)(1)(B). This standard would require that fiduciaries independently evaluate directed votes and independently vote unallocated or nonvoted shares rather than pass this responsibility on to plan participants who may not vote in the best interests of future beneficiaries, and may not take into consideration the business exigencies, stability, and future of their employer.¹⁶⁹

B. ESOPs as a Defensive Measure in Corporate Takeover Contests

1. ESOPs As Anti-Takeover Devices

The 1980's proved to be a decade of change for corporate America. Takeovers dominated the arena, as hostile mergers¹⁷⁰ turned companies inside-out and left many without jobs.¹⁷¹ The ESOP was an intricate part of this battle.¹⁷² Aside from being a tool of corporate finance, the ESOP is also often used as a strategic anti-takeover device.¹⁷³ Leveraged ESOPs with mirrored voting provisions are quite effective in thwarting takeovers because they can acquire large blocks of stock at once and place a substantial number of shares in "friendly hands."¹⁷⁴

The increased use of ESOPs as defense mechanisms has created a need for heightened judicial scrutiny.¹⁷⁵ Fiduciaries owe a duty of care and loyalty to the corporation and its shareholders.¹⁷⁶ Yet, unlike traditional trust law which prohibits

¹⁶⁹ *Joint Department of Labor/Department of Treasury Statement of Pension Investments*, 16 Pens. Rep. (BNA) 215 (Feb. 6, 1989) (encouraging trustees to consider long-term effects of employer's business operations).

¹⁷⁰ In a hostile takeover, the potential acquiror by-passes management and directly appeals to the target company's shareholders. SOLOMON, ET AL., *CORPORATIONS, LAW AND POLICY, MATERIAL AND PROBLEMS* 1172 (3d ed. 1994).

¹⁷¹ Grannis, *supra* note 13, at 851.

¹⁷² *Id.*

¹⁷³ O'Toole, *supra* note 5, at 837-38.

¹⁷⁴ *Id.* (discussing management's expectation that employees vote against potential acquiror). See also Nassau, Schwartz & Sobel, *ESOPs after Polaroid -- Opportunities and Pitfalls*, 15 EMPLOYEE REL. L.J. 347, 348 (1989) (explaining that "[e]mployees are perceived to be more concerned with the immediate benefits of job security than with the potential increase in the value of their future retirement benefits that will result from tendering their ESOP shares to a hostile acquiror.").

¹⁷⁵ Grannis, *supra* note 13, at 851-52 (discussing judicial supervision of defensive ESOPs and the task judges have untangling the intertwining business and defensive purposes of these mechanisms).

¹⁷⁶ See *supra* note 70 and accompanying text.

a trustee from holding positions of interest and acting as a fiduciary with respect to those positions, ERISA allows fiduciaries to wear two hats.¹⁷⁷ Often, corporate directors and officers act as both fiduciaries and members of management.¹⁷⁸ These dual loyalties create conflicts of interest. Commonly, a corporation will create an ESOP shortly before or at the onset of a tender offer, as it knows management will control the right to vote and tender the majority of its stock, especially when the ESOP's plan document permits mirrored voting.¹⁷⁹ Close judicial supervision of the circumstances surrounding an ESOP's creation and the transactions contemporaneous with it is necessary to determine a fiduciary's true motive.¹⁸⁰ However, assessing whether a fiduciary has acted out of personal interest or in the interests of plan beneficiaries is often a difficult task -- so difficult that courts have been unable to agree on whether an ESOP established in the midst of a tender offer shall be upheld.¹⁸¹

2. The Unocal Analysis

Generally, a court will review a fiduciary's decisions against the business judgment rule.¹⁸² However, in cases involving hostile takeovers, courts employ a stricter standard of review.¹⁸³ In *Unocal v. Mesa*,¹⁸⁴ the Delaware Supreme Court developed a heightened standard for evaluating a director's decision to employ

¹⁷⁷ Wohl, *supra* note 13 at 47 (comparing fiduciary principles of traditional trust law with those of ERISA).

¹⁷⁸ *Id.* "Once a position of dual loyalties is sanctioned . . . , it can be very difficult to determine: (1) if a fiduciary has stepped over the line and breached his or her duty of loyalty to the plan beneficiaries . . . ; or (2) if the fiduciary has merely made a mistake in judgment or simply made a reasonable investment or take a reasonable act which did not turn out as intended" *Id.*

¹⁷⁹ O'Toole, *supra* note 5, at 838 n.81 (noting that "[p]erhaps the proportional voting could be viewed as the major ESOP mechanism that 'stacks the ESOP deck' in favor of management.").

¹⁸⁰ A fiduciary breaches its duties under ERISA when his or her decisions are motivated by personal interest rather than by the best interests of the plan participants and their beneficiaries. See *Leigh v. Engle*, 858 F.2d 361, 364 (7th Cir. 1988), *cert. denied, sub nom. Engle v. Estate of Johnson*, 489 U.S. 1078 (1989). See also Grannis, *supra* note 13, at 854 (noting that "[t]he courts have long recognized that directors taking defensive actions might be acting not in the interests of shareholders but to maintain their own positions.").

¹⁸¹ CANAN, *supra* note 31, at 163-64 (discussing varied court opinions which reviewed the creation of defensive ESOPs).

¹⁸² See *supra*, notes 72 and 73.

¹⁸³ *Unocal Corp. v. Mesa*, 493 A.2d 946 (Del. 1985).

¹⁸⁴ *Id.* at 954.

certain defensive measures against hostile takeovers.¹⁸⁵ The court announced that because of the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation or its shareholders,"¹⁸⁶ the court had a duty to examine a director's conduct prior to invoking the business judgment rule.¹⁸⁷ The court reaffirmed the standard set forth in *Cheff v. Mathes*,¹⁸⁸ noting that directors must show that they had a reasonable belief that the prospective takeover threatened corporate policy and effectiveness.¹⁸⁹ However, the court stressed that the *Cheff* standard was just part of the inquiry, holding:

If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise.¹⁹⁰

The *Unocal* decision represents the willingness of courts to implement an intermediate standard of review and examine the substance of a director's decision to implement a defensive measure when faced by a hostile takeover before allowing such director the protection of the business judgment rule.¹⁹¹

3. After Unocal

Although the *Unocal* decision has provided courts with some guidance in evaluating a corporation's decision to implement an anti-takeover measure, like an ESOP,¹⁹² a clear standard for determining whether defensive ESOPs will be upheld

¹⁸⁵ *Id.* at 955-56.

¹⁸⁶ *Id.* at 954.

¹⁸⁷ *Id.* The court stated:

We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult.

Id. at 955 (quoting *Bennett v. Propp*, Del. Supr., 41 Del. Ch. 14, 187 A.2d 405, 409 (1962)).

¹⁸⁸ *Cheff v. Mathes*, 199 A.2d 548, 554-55 (Del. 1964).

¹⁸⁹ *Unocal*, 493 A.2d at 955 (Del. 1985).

¹⁹⁰ *Id.* at 954.

¹⁹¹ The intermediate standard of review is a compromise between the entire fairness test and the business judgment rule. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986). *See also* Grannis, *supra* note 13, at 856 (explaining that "*Unocal* seemed to recognize more frankly the self interest of management, and thus to encourage courts to view management decisions more skeptically.").

¹⁹² Other defensive mechanisms include poison pills, issuing large cash dividends, corporate

has yet to be established.¹⁹³ Decisions such as *Shamrock Holdings*¹⁹⁴ and *NCR Corp. v. American Telephone & Telegraph Co.*,¹⁹⁵ although inconsistent in their analytical approach to defensive ESOPs, have supplied some answers to this perplexing issue. Central to this article's analysis are the factors each court considered in either upholding or invalidating the ESOP at issue in each case.

In *Shamrock Holdings*, the Delaware Chancery Court reviewed Shamrock's claim that Polaroid's directors breached their fiduciary duties by establishing the Polaroid ESOP. Shamrock claimed that Polaroid's directors were not only misinformed and uninformed but failed to follow the test employed in *Unocal*. However, the court disagreed and upheld the validity of the ESOP, noting the overall fairness of the plan.¹⁹⁶ The court reasoned that the business judgment rule may still be applied, provided the *Unocal* standard is met first.¹⁹⁷ The court looked to four main factors in determining the fairness of Polaroid's ESOP: (1) whether the ESOP was "shareholder neutral";¹⁹⁸ (2) the ESOP's business purpose;¹⁹⁹ (3) the ESOP's defensive purpose;²⁰⁰ and (4) the ESOP's dilutive effect.²⁰¹ The court found that the ESOP was shareholder neutral, as the plan was funded in part with a 5% employee paycut.²⁰² Furthermore, the court emphasized the evidence of improved productivity.²⁰³ The court then analyzed the anti-takeover effect of the ESOP,

restructuring, share repurchases and greenmail, and defensive mergers. SOLOMON, *supra* note 171, at 1204-12.

¹⁹³ ERISA FIDUCIARY LAW, *supra* note 4, at 209.

¹⁹⁴ *Shamrock Holdings*, 559 A.2d 257.

¹⁹⁵ *NCR Corp. v. American Tele. and Tele. Co.*, 761 F. Supp. 475 (S.D. Ohio 1991).

¹⁹⁶ *Shamrock*, 559 A.2d at 276.

¹⁹⁷ *Id.* at 269-70. The court stated that "the directors must establish 'reasonable grounds for believing that a danger to corporate policy and effectiveness existed' and the defensive measure chose by the board must be 'reasonable in relations to the threat posed.'" (citations omitted).

¹⁹⁸ Whether an ESOP is "shareholder neutral" depends on who financed the ESOP. ESOPs funded by the employees through reduced compensation and benefits and which cost the shareholders nothing are "shareholder neutral." *Shamrock*, 559 at 271. *See also* Grannis, *supra* note 13, at 874.

¹⁹⁹ An ESOP is set up for a business purpose when the ESOP is created primarily to enhance employee productivity by providing employees with ownership capital. Grannis, *supra* note 13, at 851.

²⁰⁰ Grannis, *supra* note 13, at 851 (writing that an ESOP is defensive when its purpose is to help the corporation maintain control of the business by countering any hostile mergers).

²⁰¹ A dilutive effect would occur if reductions in earnings per share would exceed earnings on those shares. CANAN, *supra* note 31, at 164.

²⁰² *Shamrock Holdings*, 559 A.2d at 271.

²⁰³ *Id.* at 272.

noting that the ESOP plan allowed for confidential and mirrored voting.²⁰⁴ The court proceeded to note that it found this anti-takeover nature nonthreatening to the ESOP's fairness.²⁰⁵ Specifically, the court stated:

The evidence does establish that management has a leg up based upon its easy access to the employees and their likely concern about job security. However, there is no evidence that the ESOP is a "lock-up" or that the leg up it gives management in any way harms the company or its public stockholders. The ESOP may mean that a potential acquiror will have to gain the employees' confidence and support in order to be successful in its takeover effort. However, there has been no showing that such support is or would be impossible to obtain.²⁰⁶

Finally, the court stressed that the ESOP's dilutive effect was only speculative, due to the absence of evidence of such an effect.²⁰⁷

The court summarized its position, indicating that where employees fully fund the ESOP and have independence in voting and tendering ESOP stock, the ESOP usually, although not necessarily, will be considered fair.²⁰⁸ Other factors such as when the ESOP was implemented, the plan terms, its nature, both business and defensive,²⁰⁹ and its dilutive effect must also be considered.²¹⁰

²⁰⁴ *Id.* at 273.

²⁰⁵ *Id.* at 276.

²⁰⁶ *Id.* at 274.

²⁰⁷ *Shamrock*, 559 A.2d at 274-75.

²⁰⁸ *Id.* at 275. In its decision, the court mentioned the fact that the ESOP plan allowed for both mirrored and directed voting. Surprisingly, the court appears to favor mirrored voting, suggesting that mirrored voting makes a plan fairer than those without such a provision because it gives employees control of all the ESOP stock, not just the allocated shares. Many courts and commentators disagree with this position, and argue that mirrored voting is the single factor which makes an ESOP defensive because in the absence of such a provision, management would have no way of putting such a large amount of shares in "friendly hands." *See, e.g.*, *Grannis*, *supra* note 13, at 882; *NCR Corp.*, 761 F. Supp. at 497 (stating that "[i]f the primary purpose of the ESOP is to provide employees with better benefits, there is no need for the mirrored voting procedure."); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264-65 (2d Cir. 1984); *O'Toole*, *supra* note 5, at 859.

²⁰⁹ The court noted, "[t]he fact that the ESOP was partly defensive, however, does not make it unfair. This is a defensive device (assuming it is one) that is designed to and appears likely to add value to the company and all its stockholders." *Shamrock*, 559 A.2d at 276.

²¹⁰ *Id.*

Comparatively, in *NCR Corp.*, the Southern District Court of Ohio, applying Maryland law, upheld AT&T's counterclaim that NCR's defensive ESOP was invalid and unenforceable.²¹¹ The case arose when AT&T began a tender offer in an attempt to obtain enough NCR stock to oust its Board. Subsequent to AT&T's offer, NCR established a leveraged ESOP. AT&T claimed that the ESOP was invalid, as it was a defensive attempt to entrench management and retain control of the corporation. Unlike the *Shamrock* court who applied the *Unocal* test, the court in *NCR* applied the primary purpose test set forth by the Maryland Court of Appeals in *Cummings v. United Artists Theater Circuit, Inc.*²¹² The primary purpose test requires the court to assess the corporation's primary purpose in utilizing a defensive measure in the context of a corporate takeover.²¹³

In determining that NCR's ESOP was invalid and unenforceable, the court considered the following factors, each of which the court stressed was not dispositive in and of itself: (1) timing (i.e., the ESOP was established in the midst of AT&T's tender offer); (2) the amount of initial stock issued to the ESOP; (3) the

²¹¹ *NCR Corp.*, 761 F. Supp. at 476.

²¹² *Cummings v. United Artists Theater Circuit, Inc.*, 204 A.2d 795, 806 (Md. 1964). *Cummings* articulated the primary purpose test as follows:

[W]here a good corporate purpose is being furthered and is the principle motivation for an action by a board of directors, the fact that the consummation of such transaction may have some effect on the control of the corporation is immaterial and the agreement will stand or fall depending on whether it is fair to the corporation.

Id.

²¹³ *NCR Corp.*, 761 F. Supp. at 495. The court in *Mountain Manor Realty, Inc. v. Buccheri* expanded the primary purpose test to include a balancing test in the event that the defensive measure had both the effect of entrenching management and also served a legitimate purpose. *NCR Corp.*, 761 F. Supp. at 495. *Id.* The *Mountain Manor* court articulated this balancing test as follows:

[A]ssuming that the transaction is legal in all other respects . . . the court must look to see if there was any legitimate business purpose for the transaction other than the self-interest of the directors. If it finds such a purpose, under *Cummings* it would then have to determine whether the independent purpose was a primary or principle one, or whether conversely, the primary object was merely to manipulate control. If the court finds that the transaction was, on the whole, motivated by a legitimate corporate purpose, it should declare the sale [of stock] to be valid; if it finds to the contrary -- that the purpose of the transaction was primarily one of management's self-perpetuation and that purpose outweighed any other legitimate business purpose -- it should declare the sale to be invalid.

Mountain Manor v. Realty, Inc. v. Buccheri, 461 A.2d 45, 53 (Md. Ct. Spec. App. 1983).

mirrored voting provision; (4) the ESOP's purpose evidenced by the context of the Board's meetings; (5) the lack of opinion or input by the employee benefits department; and (6) the nature of the preferred stock such that "no rational holder" would vote against management.²¹⁴

4. An Attempt at a Bright-Line Rule of Law

Shamrock and *NCR* are difficult to harmonize, as each applies different standards from which to judge defensive ESOPs, and each arrives at different conclusions. However, both decisions look to similar factors from which the courts draw their conclusions and which may help future courts formulate a bright-line rule to guide them in determining the validity of ESOPs created in the context of tender offers. This article suggests such a rule.

This article proposes a two-prong test, entailing both subjective and objective analyses. The test's first prong consists of a subjective analysis which denotes safe harbor guidelines to which corporations can look before implementing an ESOP. This "safe harbor test" secures the validity of potentially defensive ESOPs by requiring that they exhibit certain attributes. These attributes are borrowed from factors which either the *Shamrock* or *NCR* courts found relevant in determining the validity of an ESOP created in the context of a tender offer. The "safe harbor test" massages these factors into a workable rule of law. To pass the "safe harbor test," an ESOP must have the following characteristics to be valid and enforceable if challenged by a potential acquiror during a takeover battle:

(1) A least one year prior to a potential acquiring corporation commencing a tender offer, the target corporation must have seriously considered establishing an ESOP. The target corporation must produce evidence that it intended to implement the ESOP, including, evidence of board meetings held specifically to consider establishing an ESOP, reports from both outside and internal consultants, such as financial advisors, detailing the plan to the employer's specifications, and documented input from general personnel and/or members of the employee benefits department.²¹⁵

(2) The ESOP must be unleveraged.²¹⁶

²¹⁴ *NCR Corp.*, 761 F. Supp. at 496-99.

²¹⁵ *NCR Corp.*, 761 F. Supp. at 496 (reasoning that "[t]he timing of the ESOP is, in and of itself, enough to raise an inference that it was motivated by a desire to perpetuate management control.").

²¹⁶ *Grannis*, *supra* note 13, at 861 (discussing the use of leveraged ESOPs as defensive

- (3) The ESOP must be "shareholder neutral."²¹⁷
- (4) The ESOP may hold common stock only.²¹⁸
- (5) The ESOP may not have a mirrored voting provision.²¹⁹
- (6) The corporation may issue only 5% of its stock at any one time to the ESOP.²²⁰
- (7) The ESOP must be established for the primary purpose of enhancing employee retirement benefits and not as an anti-takeover device.
- (8) The ESOP must not have a dilutive effect.²²¹

Absent any of these characteristics, the ESOP will fail the "safe harbor test." Nonetheless, the ESOP may still be enforceable under the second prong of the test -- the objective "facts and circumstances" test.

The objective analysis assesses ESOPs on a case-by-case basis, looking to all the relevant facts and circumstances to determine whether the ESOP should be upheld. As Delaware law has been most persuasive in the area of corporate law, this article suggests that *all* courts should apply the test articulated in *Unocal* (the "*Unocal* Analysis") as a basis for the "facts and circumstances test". Under this analysis, courts must ask the following two questions: (1) whether the directors had "reasonable grounds for believing that a danger to corporate policy and

measures).

²¹⁷ Shamrock, 559 A.2d at 271-72.

²¹⁸ NCR Corp., 761 F. Supp. at 498-99 (holding that "preferred stock is structured in a manner which virtually assures that no rational holder, fully appraised of the terms and conditions of the preferred stock, will vote against the incumbent Board at the special meeting.").

²¹⁹ *Id.* at 497 (emphasizing that mirrored voting provisions are meaningless to a plan whose purpose is to increase employee benefits because unallocated shares do not benefit present employees). *But see* Shamrock, 559 A.2d at 275 (implying that ESOPs with mirrored voting provisions are fairer than those without such a provision because they allow employees to control all the ESOP stock).

²²⁰ NCR Corp., 761 F. Supp. at 497 (emphasizing that large initial stock issuances to an ESOP creates the appearance that it was established to perpetuate management).

²²¹ Shamrock, 559 A.2d at 271, 274-75 (noting the fairness of large ESOPs whose dilutive effect is minimal (i.e., small reduction per share is necessary to adequately establish a plan which consequently will increase productivity)).

effectiveness existed because of another person's stock ownership,"²²² and (2) whether establishing the ESOP was "reasonable in relation to the threat posed."²²³

Indeed, management will argue that *Unocal* should not apply.²²⁴ Management will assert that the ESOP's purpose is not defensive but has the legitimate business purpose of increasing productivity and morale among the employees, and thus, courts should give deference to management's decisions by applying the business judgment rule.²²⁵ In order to alleviate the conflicts incident to defensive ESOPs, courts must look beyond management's empty assertions of business purpose and independently evaluate the substance of the management's decisions via the standards delineated in *Unocal*.

In answering the first question, courts must assess the make-up of the Board to determine if a majority of the directors were disinterested. It should determine whether those directors had a good faith basis for their decision to implement an ESOP, and it should determine whether the directors reasonably investigated the effects which the tender offer posed.²²⁶ If the court finds that a majority of disinterested directors, in good faith, independently investigated the takeover situation, the directors' burden of proving that they had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership" will most likely be satisfied.²²⁷ However, the analysis does not end there.

Courts must also determine if the directors acted in the best interests of the corporate shareholders by establishing an ESOP to defeat the perceived takeover threat.²²⁸ Courts must examine the directors' motives to assess whether they were motivated primarily to entrench management or if their motivation stemmed from

²²² *Unocal*, 493 A.2d at 955.

²²³ *Id.* But see Grannis, *supra* note 13, at 880 (suggesting a third step in the *Unocal* analysis which would examine cost and attempt to determine the board's motives for implementing a costly defense when a costless defense was available).

²²⁴ Grannis, *supra* note 13, at 878 (writing about management's probable response to avoid application of the *Unocal* standard).

²²⁵ *Id.* (noting the likelihood that management will attempt to have its decision to implement and ESOP reviewed under the business judgment rule, thus, escaping the stricter standard imposed by *Unocal*).

²²⁶ *Unocal*, 493 A.2d at 955 (discussing the first part of the *Unocal* standard).

²²⁷ *Id.*

²²⁸ *Id.* (holding that a "corporation does not have unbridled discretion to defeat any perceived threat by any Draconian means available.").

a desire to protect the corporation and its stockholders.²²⁹ *Unocal* sets forth various factors which help identify whether the adoption of an ESOP was "reasonable in relation to the threat posed."

They include:

inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange, and the shareholder interests at stake.²³⁰

Thus, the courts must apply these factors to the facts and circumstances surrounding each takeover proposal to determine whether implementing an ESOP was necessary to fend off the threat or whether the directors could have utilized less evasive means.²³¹ Based on the evaluation of the directors' motives and a review of the factors listed above, courts can determine whether an ESOP was "reasonable in relation to the threat posed."

If the ESOP fails both the "safe harbor test" and the "facts and circumstances test," the court should invalidate the ESOP and render it unenforceable. However, if an ESOP meets either test, courts would then apply the business judgment rule and give deference to the board's decision to implement an ESOP, even if, in hindsight, the ESOP proved to perpetuate management.

This article suggests that this two-part test is the best way to resolve the conflicts of interest often times present when directors implement an ESOP during the course of a tender offer. This approach would allow a court to more closely scrutinize management's decision to implement an ESOP, and it would also provide guidance to corporate directors so that they may better perform their fiduciary

²²⁹ *Id.*

²³⁰ *Id.* at 955-56.

²³¹ *Schwartz v. Marien*, 335 N.E.2d 334 (N.Y. 1975). In *Schwartz*, the court stressed: [D]isturbance of equality of stock ownership in a corporation closely held . . . calls for special justification in the corporate interest; not only must it be shown that it . . . sought to achieve a bona fide independent business objective, but as well that such objective could not have been accomplished substantially as effectively by other means which would not have disturbed proportionate stock ownership.

Id. at 338.

duties without the fear of limited liability.

IV. CONCLUSION

ESOP fiduciaries confront a vast array of potential conflicts of interest in exercising their fiduciary duties, and contemporaneously, in attempting to comply with ERISA. Tensions have flared between adopting a "hands off" judicial attitude or requiring strict judicial review of fiduciary decisions on the issues of voting and anti-takeover measures. The Department of Labor has skirted these issues somewhat, leaving an already blurred area of law even more obscure. This article suggests a simpler approach than those articulated by the Department of Labor and the courts. Although this approach is not error free, in that it may be more costly to administer and may require greater judicial supervision over the decisions of ESOP fiduciaries, it provides the guidance lacking in the judicial opinions and federal regulations which presently govern fiduciary conduct. Without the guidance of a workable rule of law, ESOP fiduciaries will continue to act blindly, perpetuating the uncertainties which plague this area of pension law.

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